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AGENDA ITEM 5a

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Revision of Dollar-Denominated Fixed Income Short-Duration Investment
- II. PROGRAM:** Fixed Income
- III. RECOMMENDATION:** Approve the reading and recommend to the Investment Committee approval of revisions to the Statement of Investment Policy for Dollar-Denominated Fixed Income Short-Duration Investment Policy

IV. ANALYSIS:

CalPERS has two short duration funds utilized by CalPERS' portfolio managers as a way to invest in the short duration sector. The High Quality LIBOR fund is a highly liquid fund primarily investing in AAA rated, floating rate assets. The Short Duration Fund is designed to provide medium liquidity and slightly higher risk profile to achieve higher returns.

Market changes during the past two years, including financial industry consolidation and changing issuance trends, have severely reduced the investment alternatives permissible under the current policy and have resulted in stagnant portfolio asset growth. Staff recommends that the policy be updated to reflect changes in the market and to provide flexibility to deal with the current environment and future market changes while also aligning CalPERS' portfolio manager with CalPERS' total fund goals.

The recommended policy revisions can be classified into three main categories:

Benchmark Change: Changing the benchmark to Federal Funds is needed to align the interests of the portfolio manager (PM) and the overall CalPERS fund. One of Fixed Income's strategic goals is to transition a large portion of the \$30 billion of externally managed cash collateral reinvestment assets to internal management. Under the current LIBOR benchmark, the PM does not have an incentive to bring in more assets as new investments are priced below LIBOR and the PM has targets above LIBOR. This has resulted in stagnant portfolio growth with most of the assets being managed externally. Since the CalPERS securities lending group utilizes Federal Funds as a benchmark in its program, a switch to Federal Funds in the Short Duration portfolios will align the interests of all parties participating in the Short Duration funds. The new benchmark is expected to increase the return on the CalPERS securities lending program through increased internally managed assets which will eliminate the management fees and provide higher alpha (historical comparisons between CalPERS and external lending agents show CalPERS produces higher returns).

Expansion of Policy Guidelines: Staff has added additional investment options and modified various policy limits to make the policy more flexible by providing the ability to further diversify the portfolio and add incremental returns.

1. Allowable Investment Revisions

- High Quality LIBOR
 - Removed the restriction on Home Equity Loan and Manufactured Housing asset-backed securities that were originally prohibited because of their lower liquidity. These asset classes have become mainstream in recent years and are now highly liquid and qualify to be included in this portfolio.

The allowable investment revisions are reflected in the following sections:

- Section V, C, 11 (page 15)
- Section V, C, 12 (page 15)

- Short Duration Fund
 - Eliminated the restriction and allowed purchases in investment grade Collateralized Debt Obligations (CDO's), Collateralized Loan Obligations (CLO's), and Collateralized Mortgage Obligations (CMO's). These asset classes have expanded in size and liquidity to allow their inclusion in the portfolio.

The investment revisions are reflected in the following sections:

- Section V, C, 5 (page 30)
- Section V, C, 8 (page 30)

- Added the ability to participate in the CalPERS Internal Asset Based Loan Program (ABL) which is currently a part of the Domestic Fixed Income Portfolio. Due to the floating rate nature of ABL and low loss rates, ABL is more appropriate for this portfolio than the longer duration domestic fixed income portfolio.

The investment revision is reflected in the following section:

- Section V, C, 11 (page 31)

2. New Products: Staff is proposing the use of Swaps to allow Staff to efficiently invest in a diversified, liquid, synthetic asset that mimics the asset classes which are allowable under the policy via the cash market. Swaps provide the ability to acquire broad market exposure in a quick and efficient manner.

The addition of swaps is reflected in the following sections:

- Section VIII, A, 3 (page 16)
- Section VIII, A, 3 (page 32)

3. Security, Sector, Weighted Average Life, and Maturity Limit Revisions: Staff has expanded the portfolio limits which will increase Staff's ability to minimize lower yielding cash and cash equivalent holdings in the portfolio while maintaining prudent asset diversification.

The policy limit revisions are reflected in the following sections:

- a. Section V, B, 5, Asset / Counterparty table (page 9)
- b. Section V, B, 5, Sector table (page 10)
- c. Section V, B, 2, Asset table (page 22 & 23)
- d. Section V, B, 5, Asset / Counterparty table (page 25 & 26)
- e. Section V, B, 5, Sector table (page 26 & 27)

See Attachment 1 for a detailed listing of these policy revisions.

Policy Simplification: The majority of the remaining changes to the policy are designed to simplify the document in an effort to make it more user friendly and easier to read. Various individual products have been consolidated into broader classifications to simplify the tables and matrices.

The following sections are examples of sections that have changes that reflect the simplification process:

- Section V, B, 2, Asset table (page 8)
- Section V, B, 5, Asset / Counterparty table (page 9)
- Section V, B, 5, Sector table (page 10)
- Section V, B, 6, Asset / Counterparty table (page 12)

- Section V, B, 2, Asset table (page 22 & 23)
- Section V, B, 5, Asset / Counterparty table (page 25 & 26)
- Section V, B, 5, Sector table (page 26 & 27)
- Section V, B, 6, Asset / Counterparty table (page 27 & 28)

Wilshire Associates, Inc. has reviewed the policy revisions and concurs with Staff's recommendation to revise the policy. (See Attachment 2)

Staff will be available to address any questions the Committee may have.

V. STRATEGIC PLAN:

This item supports Goal IV to assure that sufficient funds are available, first to pay benefits and, second to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

These changes will clarify the guidelines under which a currently managed fund is governed. The investment policy specifically targets the Short Duration funds and facilitates management's fiduciary oversight obligations.

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